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Views on the Economic Crisis

We've been in a financial crisis for a couple of years now, beginning with the subprime housing problem which the authorities initially discounted as well contained. It degenerated quickly, though. And today, there is some acceptance of the fact that it is the worst financial crisis since the end of World War II, which is a polite way of saying the worst financial crisis since the Great Depression.

Now, this financial crisis was, not to use Nassim Taleb's metaphor, not a black swan. Nassim Taleb wrote a book, the title of which is *The Black Swan*, by which he meant something that was unpredictable. Many hundreds of years ago in Europe people believed that there were only white swans because they had never seen a black swan until somebody went to Australia, came back to Europe and said, “Hey, I saw a black swan.” In other words, Nassim Taleb is saying that the mere fact that Europeans had never seen a black swan did not mean necessarily that there was no such thing as a black swan.

And yet, almost all professional investors did not see the crisis coming, even though as I said before, it was not an unpredictable event. Because they didn't see the crisis coming, they said, “Hey, nobody predicted it” or “The only ones who predicted it were people who for decades have been saying that the end is near.” It's simply not true. A few people did; people from the establishment, a very few.

I was lucky enough to come across a piece in April 2006 from the gentleman who at the time was a chief economist at the Bank for International Settlements, which is the Central Bank in Basel, Switzerland. William White said, in essence, central bankers throughout the world are very happy with themselves. They pat each other on the back when they meet in Basel, Switzerland once a month because they say, “Hey, in the early '80s we took inflation down,” and in the case of the U.S., of course, it was Paul Volcker who did it – “and then we kept inflation down and there has been overall prosperity,” although admittedly not in Japan in the '90s. So, the central bankers are very happy with themselves.

But William White says they forgot one thing and that's a major thing. They forgot that they let a credit boom go on too long and be too strong. He quoted the economists of the so-called Austrian School. These two economists have dominated the post-World War II scene throughout the world. John Maynard Keynes, the Englishman who died in 1945, but who was very popular among politicians and central bankers and ministers of finance in the '50s and the '60s, until the so-called Keynesian or post-Keynesian or even maybe pseudo-Keynesian policies that were followed in the '50s and '60s resulted in the inflationary '70s. Then, Keynes was discredited.

At the same time, the star of Milton Friedman began to shine, the advocate of monetarism, and Margaret Thatcher became Prime Minister of England in 1979. Ronald Reagan, who was a friend of Milton Friedman, became President of the United States shortly afterwards. Milton Friedman was very often right. He became famous originally because of the work he had done and because of the enormous book he had co-written with Anna Schwartz apropos the Great Depression.

Friedman and Schwartz’s emphasis in the book was on the monetary policy mistakes admittedly made by monetary authorities after the stock market crash. Friedman did not emphasize the fact that to the Austrian School of Economics was paramount, that in the Roaring '20s there was a big credit boom. It was a credit boom with very little inflation so monetary authorities did not pay too much attention to the fact --

any attention, in fact -- that they had let the post-World War I credit boom go on too long and be too strong.

To the Austrian School, the original sin, something that Friedman did not emphasize at all, was committed in the 1920s by the monetary authorities letting the credit boom go on too long and be too strong. The conclusion of the Austrians was, "Hey, you have to be very careful about credit booms because a credit bust follows a credit boom just as night follows day." And nobody listened to them in the '30s when they made that observation, apropos the Great Depression, after the original sin had been committed in the '20s. In a sense, the idea that after the credit boom you get a credit bust is something of a hopeless message. Indeed, the attitude of the Austrians was, don't try to get the economy back again quickly. You have to purge, let most of the excesses be purged from the system; which is not a very encouraging message.

Matt McLennan said, "Stability breeds instability," and in the past, and in the U.S. in the past 25 years, what we've had is a long credit boom. And, as always happens when a trend has been in place long enough, the excesses truly developed. After a long period of time, between 2002 and 2006, the excesses of the credit boom, particularly with residential real estate in the U.S., became gigantic.

And then, in 2006 residential real estate prices began to decline. Not because the U.S. was in a recession, not because interest rates were too high, but it was simply a matter that the last individual with no income, no job and no assets was provided a mortgage with no money down. And, as residential real estate prices began to decline, the credit cycle turned and the deleveraging in the financial sector and in the consumer sector began.

Now, the authorities were kind of slow in noticing that we were at the beginning of a major financial crisis. Indeed, Mr. Bernanke, the Chairman of the Fed, in late 2005 or 2006, publicly said that residential real estate in the U.S. was not in a bubble at all, and residential real estate prices had gone up because of the inherent strength of the American economy.

When somebody at a high level says something truly stupid, you have to wonder whether he's just being stupid or whether he's lying through his teeth. He knows that there is a bubble, but he doesn't want to say so for political reasons or to not dent the confidence of the public. So, most of the time, those people in high places, it's not that they are stupid, but they are acting in bad faith.

And indeed, Larry Summers in 2005 at the summer meeting, which the Fed organizes in Jackson Hole, Wyoming, a lesser known economist presented a paper that said there was trouble brewing and that a financial crisis might be around the corner. Larry Summers immediately ridiculed the poor fellow. So, neither Mr. Bernanke nor Mr. Summers saw the crisis coming.

Once the authorities could see that it was a major financial crisis, they have three ways to go. The first possibility was immediately discarded. That's what the Austrians were talking about, "Hey, there are major excesses in the system. They have to be purged." To purge the excesses at that stage would have resulted in a return to the Great Depression. It's not just a matter of the politicians liking the idea of being re-elected, but they would not like their name in the history books saying they were responsible for a return to the Great Depression. Inflation is bad but deflation is worse. So, there was no consideration whatsoever given to the idea of purging the excesses.

The second possibility was similar to what happened in Japan in the '90s after their gigantic credit bubble. The Japanese managed to avoid, after a gigantic credit bubble, a real estate credit bubble, which resulted in almost unimaginable real estate prices and abusively high stock prices. Then the double bubble burst in late 1989 and the Japanese managed to avoid a return to the Great Depression, but had economic stagnation for 10 years. American economists, including Mr. Bernanke, heavily criticized the Japanese, saying the Japanese government and central bank really botched it and their policies were miserable. My own impression is that there were policy mistakes. Everybody makes mistakes, but if the Japanese policymakers did not make mistakes, they would have had to settle for five years of economic stagnation instead of ten. In essence, there is always a price to be paid, in life as well as in finance, for the mistakes one makes.

The third way to go was full speed ahead, “Damn the torpedoes,” what the French call, the flight forward. Both Mr. Obama and Mr. Bernanke used the expression, "We will do whatever it takes," to get the economy going again as soon as possible. Let's fight the deleveraging process every step of the way, let's get credit expansion going again, let's have the banks lend. It was a combination of monetary and fiscal steps, some of them unorthodox. The monetary steps taken by the Fed had never been taken before since the Fed was created in 1913. Not only did the Fed take short-term interest rates down to practically zero very quickly, but they also engaged in quantitative easing, which is code for printing new money as quickly as possible. On the fiscal side, we're talking about a budget deficit of close to $2 trillion. Mr. Obama has already indicated that it is not just this year that the budget deficit would be gigantic, but also for several years afterwards.

Jim Grant, who writes a very interesting newsletter, has estimated that the monetary and fiscal stimulus put in place, is 10 times as big as the average stimulus during recession in the post-World War II period. I believe that it's likely, although nothing is certain, that the economy will stabilize at some point and economic recovery will begin as a result of the enormous stimulus plan.

The key question that remains is, once the economic recovery begins, will we get a recovery which is along the lines of the typical post-World War II economic recovery? After a major recession goes on for three to five years, will the economic recovery peter out quickly and go into stagnation? People talk about the paradox of savings. If you and I save, that's fine, but if the entire U.S. population starts saving, that's not good for the economy because it has an impact on consumer spending.

There is also a paradox of debt. If too much debt has been the problem, which I think it has been to a large extent, then how can adding debt on debt be the cure? The government is adding debt on debt by saying the banks have to lend again.

There is also the possibility of unintended consequences. The government and the central bank are perfectly aware that there are possible unintended consequences. But politicians tend to address today's question and if there are negative unintended consequences of today's policies, then they will have to address the problem one or two years down the road. Among the possible unintended consequences of the extremely unorthodox monetary and fiscal steps is the possibility that the dollar goes into a disorderly decline and inflation appears because of the current policies. There is no doubt that the policies are potentially widely inflationary.

The Fed is aware of this and will pull some of that extra liquidity out of the system once the economy is doing better. There are also timing problems in preventing inflation from really taking off. If Mr. Bernanke tries to pull the extra liquidity out of the system when unemployment is still high and the economy has only been improving over a short period of time, politicians will scream, "Let the good times roll," not realizing that the good times may be inflationary. Another possible unintended consequence is that Treasury note and bond yields would start going up, complicating the task of the government and the Fed considerably.

What does that mean for the stock market in the U.S. and the rest of the world? People who were selling stocks in the U.S. in February either were panicking or believed that the deleveraging taking place would ultimately cause genuine deflation, because deflation is a killer for stocks.

I always thought that the odds of deflation being the ultimate outcome were extremely low. In 2002 Mr. Bernanke wrote a paper on avoiding deflation, which he thought was a danger in 2002, even though it was not. He was repeating what Milton Friedman said before, that in a pure paper money system you can always bypass the banks. Friedman used the metaphor of the helicopter whereby raining $100 bills on the population. There is no doubt that the $100 bills would be used to spend on a variety of things.

Monetary policy could result in what they call "pushing on a string". Even if additional liquidity is provided to the banks, the banks refuse to lend because they're shaking in their boots; or if the banks are willing to lend, the consumers and corporations, also shaking in their boots, and are unwilling to borrow. So, you end up pushing on the string and deflation proceeds in spite of the Fed providing extra liquidity.

It's true that in a pure paper money system with no constraints you can always arrest deflation; create inflation by increasing nominal spending. As I said before, inflation is bad but deflation is worse, so the authorities will always choose inflation.

I do not believe that deflation would be a problem with the stimulus in place, and if necessary, there will be more stimulus put in place. The current stimulus is enough so that the economy will stabilize and start recovering. Some people say stocks are not as cheap as they were in 1974 and 1982, which is admittedly true, but at the same time, there is much less competition today from cash and treasury bonds than there was then. If I owned treasury notes or bond, I wouldn't sleep too well at night. To some extent they are an accident waiting to happen.

The attitude one takes towards various assets today is largely a function of whether or not you believe deflation will happen. If you do believe this is the case, which as time goes by looks less and less likely, then you want to own treasury bonds because even the 10-year treasury note with a yield of 3.5 percent would be much higher than that because the Consumer Price Index would go down 2, 3 or 4 percent so the true yield would be 3.5 plus 2, 3 or 4 percent.

And that raises a key question associated with what kind of economic recovery we are going to get within 6 or 12 months. If you believe that the post-World War II landscape is still in place, which is possible and maybe even probable, and the recovery will be like the post-World War II recoveries, it will go on for three to five years, corporate profits will increase and then common stocks definitely are the answer.

But if you believe that the financial crisis we're in is different, not in degree but in *nature* from previous crises, then you may harbor doubts about the economic recovery. You may be worried about the unintended consequences of the current policies, and if you believe that inflation will come within a year or two, then you want to own a combination of common stocks and gold.

I've been reading a great paper written in 1975, about what happened in Germany in the immediate aftermath of World War I and the great inflation at the time of the Weimar Republic. As inflation began to increase, the stock market kept up with inflation. Inflation accelerated to 10 or 15 percent, common stocks went up 10 to 15 percent, as opposed to cash and bonds which were a disaster.

But as inflation turns towards hyper-inflation in Germany post-World War I, there were some cases of starvation for people who were on fixed income pensions, people who held bonds and people who held cash. Their savings evaporated. Even common stocks were not quite able to keep up with hyper-inflation. I'm not saying that we're going to go into hyper-inflation, but if inflation is the ultimate outcome within a year or two, then you may want to own a combination of common stocks and gold.

I'm an adviser now, and very comfortable with Matt, Abhay and the team of in-house analysts, which I've always said is truly the heart of our operation and which is led by Bruce Greenwald. I have genuine confidence the funds will do fine in the future. It's always easy to say things, but I've put my money where my mouth is. Not only have I held on to the funds, I've never sold any or redeemed any shares from the beginning, but I've also added, in October '08 and again in April '09, to the point where it's a major percentage of my own financial assets. I genuinely believe that the team is well equipped and well positioned to do well in the future.

Average Annual Returns as of 09/30/2009:	Year to Date	1 Year	5 Years	10 Years	Expense Ratio
First Eagle Global Fund - Class A (w/o sales charge)(SGENX)	20.31%	7.49%	9.69%	12.86%	1.14%
First Eagle Global Fund - Class A(w/sales charge)(SGENX)	14.29	2.11	8.57	12.43	
First Eagle Overseas Fund - Class A (w/o sales charge)(SGOVX)	19.92	11.51	10.30	13.13	1.15%
First Eagle Overseas Fund - Class A (w/sales charge)(SGOVX)	13.92	5.93	9.18	12.70	
First Eagle Gold Fund - Class A (w/o sales charge)(SGGDX)	31.83	32.99	16.13	19.50	1.21%
First Eagle Gold Fund - Class A (w/sales charge)(SGGDX)	25.23	26.34	14.94	19.04	

Average Annual Returns as of 09/30/2009:	Year to Date	1 Year	5 Years	Inception 09/04/01	Expense Ratio
First Eagle U.S. Value Fund - Class A (w/o sales charge)(FEVAX)	19.25%	-0.90%	5.47%	8.75%	1.21%
First Eagle U.S. Value Fund - Class A (w/sales charge)(FEVAX)	13.29	-5.85	4.39	8.07	

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